

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Territory Manager
LMSB Natural Resources Territory 1410

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year Involved:
Dates of Conferences:

LEGEND:

Taxpayer	=
<u>X</u>	=
<u>Y</u>	=
<u>Z</u>	=
<u>A</u>	=
Trust 1	=
Trust 2	=
Notes	=
<u>X</u> Note	=
Agreement 1	=
Agreement 2	=
Agreement 3	=
Agreement 4	=
Agreement 5	=
Agreement 6	=

\$ <u>a</u>	=
\$ <u>b</u>	=
\$ <u>c</u>	=
\$ <u>d</u>	=
\$ <u>e</u>	=
\$ <u>f</u>	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=
Date 18	=
Date 19	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=

ISSUE:

Is Taxpayer entitled to a bad debt deduction under § 166 of the Internal Revenue Code in Year 2 in connection with the redemption of certain notes?

CONCLUSION:

Taxpayer is not entitled to a bad debt deduction in Year 2 in connection with the redemption of certain notes.

FACTS:

On Date 1, X was a majority-owned subsidiary of Taxpayer. Y was a limited liability company wholly owned by X. On Date 1, Taxpayer entered into a series of

transactions to enable X to obtain capital to execute a growth plan and business strategy, primarily through a sale of notes to private investors. Y formed Trust 1 to be an issuer of the notes and Trust 1 formed Z to be a co-issuer of the notes. X treated Trust 1 as a grantor trust on X's federal income tax returns of which X was the grantor. The Amended Trust 1 Agreement between Y, Trust 1, and the Trust 1 Trustee, also provided for: (1) a contribution by Y of \$a to Trust 1 in exchange for the entire beneficial interest in Trust 1 (Y Interest); (2) the issuance of the Notes by Trust 1 and Z for \$b which was subject to a Notes Indenture; and (3) the transfer of \$c, which equaled \$a plus \$b, by Trust 1 to X in exchange for the transfer of a note from X to Trust 1 (the X Note).

The Notes were issued on Date 1 pursuant to the Notes Indenture between Trust 1, Z, and the Notes Indenture Trustee. The Notes provided for semi-annual interest payments and a maturity date of Date 18. The Notes Indenture provided that the Notes issuers (Trust 1 and Z) granted the Notes Indenture Trustee, who acted on behalf of the holders of the Notes, a security interest in and a lien on the interests of the issuers in the X Note and all of the rights of Trust 1 as the holder of the X Note. The Notes Indenture also provided that the Notes would benefit from certain credit support provided by Taxpayer, described below.

Also on Date 1, pursuant to the X Note Indenture, X issued the X Note with an issue price of \$c to Trust 1 and Trust 1 distributed \$c, which constituted the proceeds of the sale of the Notes plus Y's contribution to Trust 1, to X. X contributed the \$c to Y for use in Y's operations. The X Note and the Notes bore the same per annum interest rate. Interest on the X Note was payable semiannually on the business day preceding the day interest was due on the Notes. The scheduled X Note interest payments would provide the cash to Trust 1 to pay the scheduled Notes interest payments. The X Note also was to provide the source of funding to redeem the Notes. The X Note matured on Date 19. Because this date was substantially later than the Notes maturity date, the X Note Indenture and Notes Indenture provided for a registered public offering of the X Note pursuant to Agreement 1 to fund the retirement or redemption of the Notes. Under the X Note Indenture and Notes Indenture, the Notes Indenture Trustee was required to cause a sale of the X Note if certain events occurred, which included the bankruptcy of X, Y, or Trust 1, and a default in the payment of interest or principal on the X Note.

To provide credit support for the X Note and the Notes, Taxpayer formed Trust 2 and entered into Agreement 2 with Trust 1, Trust 2, the Notes Indenture Trustee, and the remarketing agent. Taxpayer was required to transfer to Trust 2 cash, shares of Taxpayer's convertible preferred stock, and a demand note in exchange for 100 percent beneficial ownership of Trust 2. Taxpayer's preferred stock had an initial liquidation preference of \$b. The demand note was equal to one semi-annual interest payment on the Notes, which could be used to fund one scheduled interest payment.

Agreement 2 generally provided for the funding of a redemption of the Notes through the sale of Taxpayer's stock held by Trust 2 or the public offering of other stock issued by Taxpayer. Taxpayer had the option of issuing a new series of preferred or common stock to be sold by the remarketing agent. If the new series failed to raise the funds needed to redeem the Notes, the Trust 2 trustee was required to have the remarketing agent sell the initially contributed Taxpayer preferred shares. If the remarketing of the initially contributed Taxpayer preferred shares did not generate sufficient proceeds, Agreement 2 required Taxpayer to issue additional convertible preferred stock or common stock for remarketing. If all of the remarketing attempts failed, Agreement 2 required Taxpayer unconditionally to pay any deficiency in cash to the Notes Indenture Trustee. The Notes Indenture provided that the Notes would benefit from the support provided by Trust 2 and Taxpayer's obligations under Agreement 2 and that the rights of the Notes Indenture Trustee under Agreement 2, and to any proceeds of those rights, were solely for the benefit of the holders of the Notes and would not benefit the issuers.

The Notes Indenture provided for the mandatory early redemption of the Notes in the event of certain trigger events. These trigger events included the downgrading of Taxpayer's senior unsecured debt (under certain circumstances), a drop in Taxpayer's common stock price below a certain level, and the occurrence of an event of default. An event of default included a failure by Trust 1 to make a scheduled interest payment on the Notes and the commencement of a bankruptcy proceeding with respect to Taxpayer, X, Y, Z, Trust 1, or Trust 2.

If a trigger event occurred that would require a mandatory early redemption of the Notes, the Notes Indenture permitted (or in some circumstances, required) the Notes Indenture Trustee to enforce its rights under Agreement 2 and to enforce any rights to accelerate or sell the X Note. The proceeds from the sale of Taxpayer's stock would be used to redeem all of the Notes. Absent a trigger event, the Notes Indenture required a full or pro rata partial early redemption of the Notes only in the event of the prepayment of the X Note or certain sales of the X Note.

On Date 1, Taxpayer and Trust 1 also entered into Agreement 3. Agreement 3 provided that if X failed to make a scheduled payment of interest on the X Note, Taxpayer had the option to advance Trust 1 the funds necessary to make the scheduled interest payment on the Notes.

Agreement 2 provided generally that Trust 1 was obligated to reimburse Taxpayer for cash paid by Taxpayer to the Notes Indenture Trustee pursuant to Agreement 2 and amounts drawn against Taxpayer's demand note in Trust 2 to make payments on the Notes. Agreement 3 provided that Trust 1 was obligated to reimburse Taxpayer for any payments made by Taxpayer to the Notes Indenture Trustee on behalf of Trust 1. Taxpayer's reimbursement rights existed only after the Notes were repaid,

with interest, in full. The Notes Indenture provided that Taxpayer's rights to reimbursement under Agreement 2 and Agreement 3 were secured by the X Note.

To summarize, as a result of the above agreements and transactions, the X debt issuance and the credit support provided by Taxpayer had the following structure in Year 1:

- 1) Trust 1, wholly owned by Y, and Z, wholly owned by Trust 1, issued jointly \$b of Notes to private investors;
- 2) Y transferred \$a to Trust 1;
- 3) X issued the X Note to Trust 1 in exchange for \$c, which equaled \$a plus \$b, in cash;
- 4) The X Note was held by the Notes Indenture Trustee as security for Trust 1's obligations to pay the principal of, and interest on, the Notes and as a source of funds for repayment of the Notes;
- 5) X contributed to Y the \$c it obtained from the issuance of the X Note for use in Y's operations; and
- 6) Taxpayer issued preferred stock and a demand loan to Trust 2 to provide credit support for the X Note and the Notes.

On Date 2, Taxpayer distributed almost all of X's stock to Taxpayer's shareholders, after which X and Y no longer were part of Taxpayer's consolidated return group. Thereafter, X's financial and operating position deteriorated. By early in Year 2, a mandatory redemption of the Notes and remarketing of the X Note were possible because of the occurrence of a trigger event such as a bankruptcy filing by X or a credit downgrade of Taxpayer.

Taxpayer attempted to manage its financial exposure under the credit support arrangement by seeking amendments to certain key provisions of the Notes Indenture and by adding some additional means to enforce its obligations under Agreement 2. In order to obtain the necessary agreement from the holders of the Notes, Taxpayer offered to add new protections for the holders of the Notes, to make certain payments to the holders, and to make certain additional payments or exchange its own notes for the Notes. In return, Taxpayer sought the holders' agreement to amend the Notes Indenture to: (1) eliminate the trigger that would force a mandatory early redemption for a stock price/credit downgrade; (2) eliminate the bankruptcy of X, Y, or Z as events of default that could accelerate the redemption of the Notes; (3) include Taxpayer's obligations under a new Agreement 4 as security for the Notes; (4) include Trust 1's repayment obligations to Taxpayer under Agreement 4 as a secured obligation of Trust 1; and (5) allow Taxpayer to use sources other than an equity issuance to provide funds to redeem the Notes.

Taxpayer also agreed to amend the X Note Indenture to: (1) allow X to defer payments of interest on the X Note so long as Taxpayer performed its obligations under

Agreement 4; and (2) provide that this interest deferral would not cause the X Note to be remarketed or accelerated. Taxpayer further agreed to make the two interest payments on the X Note scheduled in Year 2 without any right to reimbursement from X.

Taxpayer obtained the necessary consents from the holders of the Notes and entered into Agreement 4 with Trust 1 on Date 3. In Agreement 4, Taxpayer affirmed its obligation under Agreement 2 to make deficiency payments to the Notes Indenture Trustee on behalf of Trust 1. Agreement 4 provided that, if the Indenture Trustee lacked sufficient funds, Taxpayer was obligated to provide the Notes Indenture Trustee with sufficient funds to pay: (1) all administrative expenses and accrued and unpaid interest amount on the Notes if not paid by the interest payment date; (2) if no trigger event occurred, all administrative expenses, accrued and unpaid interest, and principal balance of the Notes upon maturity; and (3) if a certain trigger event occurred, all administrative expenses, accrued and unpaid interest, and the applicable mandatory redemption price for the Notes by the mandatory redemption date. Taxpayer agreed that Agreement 4 would be discharged only by a complete payment of the amounts payable under the Notes.

Taxpayer's rights and obligations under Agreement 2 and Agreement 3 remained in effect after Taxpayer entered into Agreement 4. Also on Date 3, Trust 1 and Z amended the Notes Indenture to include Agreement 4 and the rights of Trust 1 and Z under Agreement 4 as security for the Notes.

Taxpayer made the first Year 2 scheduled interest payment on the X Note to the Notes Indenture Trustee and Trust 1 made the first Year 2 scheduled interest payment on the Notes.

On Date 4, X filed for bankruptcy protection, which automatically accelerated the X Note. As a result, under the Notes Indenture, Taxpayer had the right to direct the sale of the X Note at the highest reasonably available market price.

On Date 5, Taxpayer offered to exchange its own notes (Taxpayer Notes) for the Notes. Taxpayer Notes had a maturity date of Date 18. Taxpayer exchanged the Taxpayer Notes for almost all of the Notes on Date 6, and purchased for cash the remainder of the Notes by Date 9. Taxpayer has been allowed a bad debt deduction with respect to the Notes purchased for cash, and this amount is not at issue. Taxpayer then became the sole holder of the Notes. Taxpayer redeemed the Taxpayer Notes in Years 3 and 4.

On Date 7, Taxpayer and A entered into Agreement 5, in which A agreed to purchase certain claims that Taxpayer had against X and its affiliates and to purchase the X Note for \$d from Trust 1. Under the Notes Indenture, the amounts received from the sale of the X Note were required to be used to make a pro rata partial early

redemption of the Notes. On Date 8, Taxpayer sold the X Note to A in exchange for A's promise to pay \$d.

Taxpayer made the second Year 2 scheduled interest payment on the X Note to the Notes Indenture Trustee and Trust 1 made the second Year 2 scheduled interest payment on the Notes. As the holder of almost all of the Notes at this time, almost all of the interest was paid to Taxpayer.

Pursuant to Agreement 6, dated and effective Date 8, among Taxpayer, X, and Y, Y transferred Y Interest (the entire beneficial interest) in Trust 1 to Taxpayer and Trust 1 transferred the stock of Z to Taxpayer. At this time, Trust 1's only asset was the account receivable from A of \$d for the X Note. Agreement 6 also required X and its affiliates to take all actions requested by Taxpayer to amend the Notes Indenture and to operate or terminate Trust 1.

On Date 9, at Taxpayer's direction, Trust 1, Z, and the Notes Indenture Trustee amended the Notes Indenture to provide Taxpayer with the same rights as other holders of Notes to vote on or consent to matters for which a vote was required under the Notes Indenture.

On Date 10, at Taxpayer's direction, Trust 1, Z, and the Notes Indenture Trustee amended the Notes Indenture to give Trust 1 and Z, now owned by Taxpayer, the ability to make an optional redemption of the Notes at any time before the maturity date.

On Date 10, Taxpayer and Trust 1 also entered into Amendment No. 1 to Agreement 4, which obligated Taxpayer to make a payment to the Notes Indenture Trustee to fund an optional redemption of the Notes by Trust 1 if Trust 1 lacked the necessary funds to pay interest, principal, and administrative expenses in connection with an optional redemption. As the holder of all of the Notes at this time, Taxpayer would receive all of the payments of principal and accrued interest upon their optional redemption.

Taxpayer's business purpose for amending the Notes Indenture and for Amendment No. 1 to Agreement 4 was to enable Taxpayer to fulfill its obligations under Agreement 4 in Year 2 in order to claim a corresponding bad debt deduction in Year 2, as well as eliminate administrative expenses of Trust 1.

On Date 10, after execution of the amendments to the Notes Indenture and of Amendment No. 1 to Agreement 4, Taxpayer caused the issuers (Trust 1 and Z) to make an optional early redemption of the Notes. Trust 1's only source of funds at this time was the amount due from A for the X Note, which was required under the Notes Indenture to be used to fund a pro rata partial early redemption. Taxpayer was the only other source of funds for the early redemption.

On Date 11, Trust 1 and Z, now owned by Taxpayer, began to redeem the Notes through seven installments using funds provided through the bank account that held Taxpayer's general cash funds. The redemption was conducted in installments because of the limited amount of cash in Taxpayer's account. Each time, Taxpayer wired an amount (approximately, \$e) from its bank account to the Notes redemption account of the Notes Indenture Trustee. After a deduction for fees, the Notes Indenture Trustee wired the remaining amount to the account of the depositary holding the Notes as the nominee holder of the Notes. The depositary redeemed \$e principal amount of the Notes, and disbursed \$e plus accrued interest to Taxpayer as the holder of the redeemed Notes by wiring that amount to Taxpayer's bank account. This transaction was repeated on Date 12, Date 13, Date 14, Date 15, Date 16, and Date 17.

On Date 11, Taxpayer received the payment of \$d from A for the sale of the X Note and held these funds from Date 11 to Date 12. On Date 12, Taxpayer wired approximately \$e, which equaled \$d, the amount earned from investment of \$d between Date 11 and Date 12, and \$f, from its bank account to the Notes redemption account of the Notes Indenture Trustee. These funds were used to redeem and pay accrued interest on \$e of the Notes.

For the taxable year Year 2, Taxpayer claimed a bad debt deduction under § 166 for the amounts that Taxpayer had paid on the basis of Amendment No. 1 to Agreement 4. The claimed deduction gave rise to a net operating loss for Year 2, which Taxpayer carried back. The amount claimed was the total of the amounts transferred in the circular transactions made on Dates 11 through 17, which comprised the principal amount of the Notes, less the \$d proceeds from the sale of the X Note to A (and the interest thereon).

LAW AND ANALYSIS:

Section 166 provides, in the case of a corporation, a deduction for any debt that becomes worthless during the taxable year.

Section 1.166-9(a) of the Income Tax Regulations provides that a payment of principal or interest in discharge of part or all of a taxpayer's agreement to act as, or in a manner essentially equivalent to, a guarantor, endorser, or indemnitor of, or other secondary obligor upon, a debt obligation, is treated as a business debt becoming worthless in the taxable year of payment. Under § 1.166-9(d), a payment may be treated as a worthless debt only if: (1) the agreement was entered into in the course of the taxpayer's trade or business or a transaction for profit; (2) there was an enforceable legal duty upon the taxpayer to make the payment (except that legal action need not have been brought against the taxpayer); and (3) the agreement was entered into before the obligation became worthless or partially worthless. An agreement is considered as entered into before the obligation became worthless if there was a reasonable expectation on the part of the taxpayer at the time the agreement was

entered into that the taxpayer would not be called upon to pay the debt (subject to such agreement) without full reimbursement from the issuer of the obligation.

Section 671 provides that where it is specified in subpart E of part I of subchapter J that the grantor or another person is treated as the owner of any portion of a trust, there is included in computing the taxable income and credits of that person those items of income, deduction, and credits against tax of the trust that are attributable to that portion of the trust to the extent that the items would be taken into account in computing taxable income or credits taken against the tax of an individual.

Section 677 provides that a grantor is treated as the owner of any portion of a trust, whether or not the grantor is treated as such under § 674, whose income, without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be, distributed to the grantor, or held or accumulated for future distribution to the grantor.

Section 1.671-2(e)(1) provides that for purposes of part I of subchapter J, chapter 1, a grantor includes any person to the extent that person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.

Section 1.671-2(e)(3) provides that a grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in § 301.7701-4(c), liquidating trusts described in § 301.7701-4(d), or environmental remediation trusts described in § 301.7701-4(d).

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that if a grantor is treated as the owner of the entire trust, the grantor is treated as the owner of the trust's assets for federal income tax purposes.

We conclude that Taxpayer is not entitled to a bad debt deduction in Year 2 because:

1. Taxpayer is the grantor and owner of Trust 1 and is treated as the owner of the assets of Trust 1, and transactions between Taxpayer and Trust 1 are not recognized for federal income tax purposes.
2. Taxpayer discharged its obligation on the Notes only in Years 3 and 4, when it redeemed the Taxpayer Notes that Taxpayer substituted for the Notes.
3. The circular transfers of cash on Dates 11 through 17 did not constitute payment.
4. Taxpayer was not under a legally enforceable duty to pay the Notes.

Taxpayer was a grantor of Trust 1 and transactions between Taxpayer and Trust 1 are disregarded for tax purposes

Taxpayer is a grantor and owner with respect to Trust 1 and as a result, may not properly claim a bad debt deduction in connection with Trust 1's redemption of the Notes from Taxpayer. A grantor that is treated as the owner of the entire trust is treated as the owner of the trust's assets. Therefore, a promissory note of the trust that is held by the grantor is disregarded for federal income tax purposes because a taxpayer cannot be both the obligee and obligor on a debt instrument.

The transaction is properly characterized as follows: (1) prior to Date 8, X, the seller and grantor, was treated as the owner of Trust 1 under § 677; (2) if a grantor is treated as the owner of the entire trust, the grantor is treated as the owner of the trust's assets for federal income tax purposes, and X's sale of the beneficial ownership interest in Trust 1 to Taxpayer is treated as a sale of X's assets; (3) Taxpayer therefore is treated as purchasing the assets of Trust 1; (4) Taxpayer is treated as forming a new trust; and (5) Taxpayer is treated as contributing the Trust 1 assets to the new trust. Taxpayer thus is treated as a grantor with respect to Trust 1 pursuant to § 1.671-2(e)(1), which provides that the term "grantor" includes a person who makes a non-gratuitous transfer of property to a trust, and as an owner under § 677. As a result, Taxpayer may not properly claim a bad debt deduction to discharge its obligation on the Notes through the redemptions on Dates 11 through 17 because transactions between Taxpayer and Trust 1 are disregarded for federal income tax purposes.

Taxpayer's bad debt deduction is proper only in the taxable years Taxpayer pays the Taxpayer Notes

We conclude that Taxpayer was, or acted in a manner essentially equivalent to, a secondary obligor of the Notes, and that § 1.166-9 determines Taxpayer's entitlement to a bad debt deduction. Accordingly, Taxpayer may properly claim a bad debt deduction only when Taxpayer makes a payment that discharges its obligation. Taxpayer agrees that § 1.166-9 applies, but asserts that its obligations ran only to Trust 1 and that it discharged those obligations through payment when it redeemed the Notes on Dates 11 through 17. We conclude that Taxpayer did not make a payment in discharge of its obligations until it redeemed its own notes in Years 3 and 4.

Black Gold Energy Corp. v. Commissioner, 99 T.C. 482 (1992), holds that a taxpayer that substitutes its own debt for debt it has guaranteed may claim a bad debt deduction only when it pays the substituted debt. The taxpayer guaranteed the debt of a corporation in which the taxpayer had a controlling interest. After the corporation defaulted on its payments to the bank and filed for bankruptcy, the bank filed suit against the taxpayer to recover under the taxpayer's guarantees. The taxpayer and the bank entered a settlement agreement in 1984 in which the taxpayer substituted its own note to the bank for the guaranteed debt. The note provided for an 8-year repayment schedule with monthly installments beginning in 1985. The taxpayer claimed, on its

1984 corporate tax return, a bad debt deduction for the entire principal sum due the bank. The court concluded that a note issued by a guarantor in satisfaction of guaranteed debt does not constitute a payment of the guaranteed debt in discharge of the guarantor's obligation for bad debt deduction purposes until the note is paid, and disallowed the deduction for 1984. The taxpayer was entitled to a bad debt deduction only in 1985 for amounts paid to the bank in 1985.

The rule that issuance of a note does not constitute payment, and that a bad debt deduction is deferred until a note issued in satisfaction of a debt is paid, arose in cases involving taxpayers using the cash receipts and disbursements method of accounting. Helvering v. Price, 309 U.S. 409, (1940); Eckert v. Burnet, 283 U.S. 140 (1931); Perry v. Commissioner, 49 T.C. 508 (1968); Alexander v. Commissioner, T.C. Memo. 1995-334; Blumeyer v. Commissioner, T.C. Memo 1992-647; Franco v. Commissioner, T.C. Memo. 1992-577. The taxpayer in Black Gold Energy Corp., who used an accrual method of accounting, argued that this rule should be limited to cash basis taxpayers. However, "payment" has the same meaning for an accrual basis as for a cash basis taxpayer. Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977). Accordingly, the court in Black Gold Energy Corp. rejected the taxpayer's argument, holding that the taxpayer's deduction under § 166 was proper only when the substituted notes were paid regardless of the taxpayer's method of accounting. See also Flint Industries, Inc. v. Commissioner, T.C. Memo 2001-276.

Taxpayer concedes that if Taxpayer was a guarantor, endorser, indemnitor, or other secondary obligor with respect to the Notes, and issued the Taxpayer Notes in settlement, discharge, or substitution of a secondary obligation to the holders of the Notes, then the principles of Black Gold Energy Corp. preclude Taxpayer from claiming a bad debt deduction until Taxpayer redeemed the Taxpayer Notes. Taxpayer argues, however, that Black Gold Energy Corp. does not apply because, under Agreements 2 and 4, Taxpayer's obligations ran not to the holders of the Notes but to Trust 1. Taxpayer claims that it had no liability to the holders of the Notes that it could settle, discharge, or substitute by issuance of its own notes. Therefore, Taxpayer asserts, when Taxpayer issued the Taxpayer Notes in exchange for the Notes, it was not substituting the notes for debt on which it was obligated, and the exchange did not discharge its obligations under Agreements 2 and 4. Taxpayer characterizes the nature of these obligations as a "keep well" agreement that merely provided credit support for the X Note.

We conclude, however, that, despite the lack of contractual privity with the holders of the Notes, Taxpayer's credit support was in the nature of direct obligations to the holders, as evidenced by: (1) the Notes Indenture; (2) Agreement 2; (3) Agreement 4; and (4) Amendment No. 1 to Agreement 4.

Taxpayer entered into Agreement 2 with the Notes Indenture Trustee among others. The Notes Indenture Trustee acted on behalf of and represented the holders of

the Notes. The Notes Indenture provided that the Notes would benefit from Taxpayer's obligations under Agreement 2. Although Taxpayer entered into Agreement 2 with the Notes Indenture Trustee, among others, and not the Notes holders, Agreement 2 provided that Taxpayer's obligations under Agreement 2 and any proceeds of those rights were solely for the benefit of the holders, not Trust 1.

Further, as described in the Notes Indenture and Agreement 2, upon a trigger event, the Notes Indenture Trustee was required to deliver notice to a remarketing agent to commence the process of remarketing Taxpayer's stock to fund redemption of the Notes. The remarketing procedures required Taxpayer to pay any deficiency in cash to the Notes Indenture Trustee. Taxpayer's obligation was absolute and unconditional. All proceeds from remarketing could be used only to redeem the Notes. The remarketing process reflects an obligation by Taxpayer to the holders of the Notes.

As stated in Agreement 4, pursuant to Agreement 2, Taxpayer was required, under certain circumstances, to make deficiency payments to the Notes Indenture Trustee on behalf of Trust 1. In reality, Taxpayer was obligated to make the deficiency payments to the holders of the Notes via the Notes Indenture Trustee, not Trust 1. Trust 1 merely provided a vehicle to direct Taxpayer's payments from the Taxpayer to the holders. Agreement 4 further emphasized Taxpayer's obligations to make payments of interest, principal, and administrative expenses to the Notes Indenture Trustee, promptly upon demand made by Trust 1 or the Notes Indenture Trustee. Thus, the holders of the Notes could demand, via the Notes Indenture Trustee, that Taxpayer pay these amounts. Taxpayer also agreed in Agreement 4 that its obligations would not be discharged except by a complete payment of amounts payable under the Notes. Taxpayer's only purpose under Agreement 4 was to pay amounts due under the Notes. Taxpayer affirmed this obligation through Amendment No. 1 to Agreement 4 in the case of an optional redemption.

All of these agreements reflected Taxpayer's obligation to redeem the Notes if the issuers were unable to do so. Taxpayer's purpose in entering into these agreements may have been to provide credit support for the X Note and the Notes, but it did so by creating obligations to the Notes holders enforceable by their representative, the Notes Indenture Trustee. Taxpayer's issuance of the Taxpayer Notes substituted new debt for the original debt it was obligated to redeem. Taxpayer discharged its obligations toward the Notes holders that exchanged Notes for Taxpayer Notes only when Taxpayer redeemed the Taxpayer Notes.

Furthermore, we do not read the principles underlying Black Gold Energy Corp. as requiring contractual privity with or direct obligations to the debt holders. Black Gold Energy Corp. merely states (and applies to accrual basis taxpayers) the principle enunciated in Helvering v. Price and Eckert v. Burnet, that a taxpayer that claims a bad debt deduction as a result of paying the debt of another party (as opposed to a deduction that arises through the worthlessness of a debt owed to the taxpayer directly)

is entitled to that deduction only when it pays that debt. If a note is issued for the debt, payment occurs when that note is paid.

This principle also underlay Putnam v. Commissioner, 352 U.S. 82 (1956), in which the Court held that a taxpayer's loss that resulted from a discharge of an obligation as a guarantor of notes was deductible as a bad debt rather than as a loss incurred in a transaction for profit. The Court reasoned, in part, that a guarantor steps into the shoes of the original creditor. The guarantor discharges its obligation by paying the primary obligor's debt, at which point the primary obligor owes a debt to the payor. This debt being worthless, the payor may take a bad debt deduction. The rationale applies whether or not there is an express right of subrogation. In re Vaughan, 719 F. 2d 196 (6th Cir. 1983); Horne v. Commissioner, 523 F.2d 1363 (9th Cir. 1975); Stratmore v. U.S., 420 F. 2d 461 (3rd Cir. 1970); Martin v. Commissioner, 52 T.C. 140 (1969); Black Gold Energy Corp. v. Commissioner.

Putnam and Black Gold Energy Corp. involved guarantor obligations, but the rationale of those cases has been applied broadly to other indirect credit support mechanisms. See Horne v. Commissioner at 1365 (the loss resulting from the worthlessness of a bad debt includes not only "any loss sustained by the obligee of the debt but also any loss sustained by a third party, whether acting as surety, guarantor, or indemnitor") (emphasis supplied); U.S. v. Hoffman, 423 F.2d 1217, 1218 (9th Cir. 1970) ("the essence of [Putnam] was to protect the statutory scheme for a common tax treatment of all losses suffered by a corporate stockholder in providing his corporation with financing"); Stephens Group v. Commissioner, T.C. Memo 1995-158 (pledge analogized to a guarantee).

Section 1.166-9 incorporates the principle that any taxpayer that claims a bad debt deduction as a result of discharging an obligation to pay the debt of another party is entitled to that deduction only when it pays that debt. Section 1.166-9(a) applies to a taxpayer's agreement, not only to act as guarantor, endorser, or indemnitor of, or other secondary obligor upon a debt obligation, but also to act in a manner essentially equivalent to a guarantor, endorser, indemnitor, or other secondary obligor. This language is sufficiently broad to encompass the full range of arrangements in which a taxpayer's deduction arises from the payment of another party's debt.

We conclude, therefore, that the holding of Helvering v. Price, Eckert v. Burnet, and Black Gold Energy Corp., that a taxpayer obligated on the debt of another party may claim a bad debt deduction when it discharges that obligation through payment, and that payment occurs only when the taxpayer pays any note substituted for the original debt, applies to all arrangements within the scope of § 1.166-9(a). This includes any bad debt deduction that is premised on the taxpayer's payment of a debt of another party regardless of the nature of the taxpayer's obligation. Taxpayer's characterization of its obligations as running solely to Trust 1 and not to the holders of the Notes, as "credit support" or a "keep well" agreement, is immaterial.

Therefore, we conclude that Taxpayer's position was analogous to the taxpayer in Black Gold Energy Corp. and that Taxpayer may not claim a bad debt deduction with respect to the Notes until Years 3 and 4, when it discharged its obligations under Agreements 2 and 4 by paying the Taxpayer Notes.

The circular transfers of cash on Dates 11 through 17 were not payments for purposes of § 1.166-9

Taxpayer acknowledges that it effected the transfers of cash on Dates 11 through 17 in order to accelerate the bad debt deduction with respect to the Notes to Year 2. By this means, Taxpayer apparently attempted to "pay" the Notes in order to comply with the payment requirements of § 1.166-9. These circular transfers did not constitute payment of Taxpayer's obligation with respect to the Notes. Payment requires the expenditure of cash or its equivalent. Eckert v. Burnet; Helvering v. Price; Battelstein v. Internal Revenue Service, 631 F.2d 1182 (5th Cir. 1980); Black Gold Energy Corp. v. Commissioner. Taxpayer expended no funds in redeeming the Notes, as all the cash transferred was returned to it, and the cash transfers on Dates 11 through 17 were not payment.

Battelstein v. Internal Revenue Service holds that a circular transfer of cash from a lender to a creditor and back did not constitute a payment of interest. The taxpayer claimed deductions for interest paid on a loan. The lender agreed to make future advances of interest costs on the loan as they became due. The taxpayer agreed to issue the lender a check for the current interest due, and the lender agreed to issue the taxpayer a check in the identical amount. The court held that this "check exchange scheme" resulted in no interest being paid and disallowed a deduction under § 163. The court concluded that the checks, which were issued by the lender in the exact amount as the taxpayer's current interest obligations, had no purpose other than financing the taxpayer's interest obligations to the lender. This arrangement only served to defer the actual payment of interest and was a sham that should be ignored. See also Wilkerson v. Commissioner, 655 F.2d 980 (9th Cir. 1981) (interest is not paid under an arrangement in which a part of loan proceeds is specifically earmarked for the purpose of paying the interest); Menz v. Commissioner, 80 T.C. 1174, 1189 (1983).

Circular transfers of funds also are not payment for purposes of the bad debt deduction. The taxpayers in Alexander v. Commissioner were denied a bad debt deduction when they discharged a guarantee obligation with funds borrowed from the same lender. Blumeyer v. Commissioner denied a bad debt deduction although the taxpayer borrowed funds from one lender to discharge a loan guarantee with a different lender, because the taxpayer exercised no control over the funds. See also Franco v. Commissioner.

These cases involve circular transfers of cash that originated with and returned to a lender. The lender loaned the funds to a taxpayer/creditor who used the cash to pay interest or to retire the debt. The conclusion that such an arrangement is not payment is equally applicable to the circular transfers of cash on Dates 11 through 17, when the funds originated with and returned to Taxpayer as both payor and payee. Taxpayer prearranged each transaction to circulate \$e each time, knowing that the amount would return to Taxpayer's bank account. The amounts were specifically earmarked for the purpose of redeeming the Notes in time to take a bad debt deduction in Year 2. This arrangement allowed Taxpayer to redeem \$b of Notes with only \$e. If Taxpayer had not been assured that \$e would be returned to it, the full redemption would not have been possible. Most importantly, there was no change in Taxpayer's economic position. At the end of the transactions, Taxpayer possessed approximately the same amount of cash as at the beginning. This arrangement did not constitute payment.

Taxpayer argues that the above cases are distinguishable because there was never an arrangement between Taxpayer and Trust 1 that Trust 1 would return the amounts to Taxpayer. We disagree. Taxpayer was the holder and payee of the Notes. As such, Taxpayer had the right, under the Notes Indenture, to the payments of interest and in redemption of the Notes. Furthermore, at this point Taxpayer was the owner of Trust 1, had caused the parties to make amendments to the underlying documents necessary to allow the redemptions to occur, and could direct Trust 1 to take any action. An additional formal agreement between Taxpayer and Trust 1 was unnecessary.

We conclude then that Taxpayer is not entitled to a bad debt deduction in Year 2 because the transfers of cash in Year 2 that originated with and returned to Taxpayer did not constitute payment of the Notes.

Taxpayer was not under a legally enforceable duty to make payment

Section 1.166-9(d)(2) requires that there be an enforceable legal duty upon the taxpayer to make payment. No deduction is available under § 166 if a payment is voluntary. Wortham Machinery Co. v. U.S., 521 F.2d 160, 164 (10th Cir. 1975).

Taxpayer argues that Taxpayer remained obligated to make payments to Trust 1 in discharge of its obligations under Agreement 2 after its acquisition of the Notes. We conclude that Taxpayer's redemption of the Notes was voluntary. By Dates 11 through 17, Taxpayer had complete power over Trust 1, Z, and the Notes Indenture Trustee, specifically directed those parties to amend the necessary documents to allow Taxpayer to redeem the Notes in Year 2, before maturity, and was in full control of the transactions. Taxpayer essentially obligated itself to redeem the Notes in Year 2. In fact, any redemption by Taxpayer of the Notes was voluntary because Taxpayer was both the payor and payee and was enforcing its obligations against itself. See Rev. Rul. 80-228, 1980-2 C.B. 115 (a taxpayer cannot be liable for a debt to itself). On Dates 11 through 17, the only independent parties that could enforce an obligation against

Taxpayer were the holders of the Taxpayer Notes, which Taxpayer did not pay until Years 3 and 4. Therefore, Taxpayer was not under a legally enforceable obligation to pay the Notes in Year 2 or at any time, and Taxpayer is not entitled to a bad debt deduction as a result of redeeming the Notes in Year 2.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.